THE WALL STREET JOURNAL.

Fed Cuts Key Interest Rate As Recession Fears Well Up

January 22, 2008

The Federal Reserve, confronted with a global stock sell-off fanned by increased fears of a recession, cut its target for the federal funds rate by three-quarters of a percentage point to 3.5%, the biggest single cut in interest rates since August 1982.

The Fed, in a departure from recent tradition of moving rates at regularly scheduled meetings of policy makers, took the action week before its scheduled January 29-30 meeting "in view of a weakening of the economic outlook and increasing downside risks to growth." (Read the Fed's statement.1)

Stocks tumbled initially, with the Dow Jones industrials down more than 400 points soon after opening, but markets recovered by midmorning amid strength in financial shares. (Read related article.2)

The Fed hinted that it is prepared to keep cutting rates if necessary, saying, "Appreciable downside risks to growth remain. The Committee will continue to assess the effects of financial and other developments on economic prospects and will act in a timely manner as needed to address those risks. "

"This is very constructive and I think it shows this country and the rest of the world that our central bank is nimble and can move quickly in response to market conditions," Treasury Secretary Henry Paulson said following the move.

After the Fed announcement, trading in the federal funds futures contracts indicated markets anticipate the Fed will bring the target for the federal funds rate to 2.75% by mid-March.

Fed officials have been particularly concerned that falling markets could lead financial institutions to sell assets or pull back on lending, exacerbating the market decline and worsening a credit crunch. Federal Reserve Chairman Ben Bernanke signaled his growing concern about the economy when he last week endorsed fiscal stimulus to assist the Fed in heading off or moderating a recession.

Separately, the Bank of Canada Tuesday trimmed its benchmark overnight rate by a quarter percentage point for the second consecutive time, the first back-to-back reduction since 2004, and said more reductions are likely needed in the "near term" as the worsening U.S. economy drags on Canadian exports and inflation and economic growth slows. The move was expected and occurred at a regularly scheduled meeting.

The Federal Reserve made an emergency 0.75% rate cut, the largest move in a quarter century. Economics reporter Sudeep Reddy discusses the implications.

The fed fund rates, at which banks lend to each other overnight, is primarily influenced by the Fed. The Federal Open Market Committee -- the Fed governors in Washington and five of the 12 regional Fed bank presidents -- set a target for the rate. William Poole, president of the St. Louis Federal Reserve Bank, cast the sole dissent; the Fed said he didn't believe that current conditions justified policy action before the regularly scheduled meeting next week. Absent and not voting was Fed governor Frederic S. Mishkin.

The Fed has now cut its target by a sharp 1.75 percentage points since August 2007, and brought the fed funds rate target to a level last seen in August 2005. The last time the Fed cut rates by over three-quarters of a percentage point in a single action was in August 1982. The last move of this size was an increase in November 1994.

The Fed statement it expects inflation to moderate in coming quarters, "but it will be necessary to continue to monitor inflation developments carefully."

The discount rate, at which the Fed lends directly to banks, also was lowered by three-quarters of a percentage point to 4%. In a sign that the Fed action was taken quickly, the discount rate move was made by the Federal Reserve Board in response to request submitted by just two of the 12 Fed banks, the Federal Reserve Banks of Chicago and Minneapolis.

After Fed cut, Ian Lyngen, interest rate strategist at RBS Greenwich Capital, said the move was a "clear sign from the Fed that they are, as the Chairman has said in recent weeks, willing to act and act decisively." RBS sees an additional half percentage point in easing, if the market demands it, which RBS analysts think it will.

Added SEB economist Henrik Degrer says the slumping US stock market was giving a "double-whammy" to growth prospects along with the US housing market slowdown. Says the cut is likely to boost the stock market in the near term and provide helpful, medium-term support to the housing market. Says, however, he still sees the Fed cutting again next week, by a half percentage point.

"This is excellent news and something that's needed to help reverse the psychology in the market," Jacob Frenkel, vice chairman of US insurance giant AIG, and a former chief economist of the International Monetary Fund, told Dow Jones Newswires ahead of the World Economic Forum in Davos about the Fed's big interest rate cut.